

VZCZCXRO3060
PP RUEHRG
DE RUEHBR #0788/01 1141900
ZNR UUUUU ZZH
P 241900Z APR 06
FM AMEMBASSY BRASILIA
TO RUEHC/SECSTATE WASHDC PRIORITY 5190
INFO RUEHRI/AMCONSUL RIO DE JANEIRO 1928
RUEHSO/AMCONSUL SAO PAULO 6808
RUEHRG/AMCONSUL RECIFE 4648
RUEHBU/AMEMBASSY BUENOS AIRES 3952
RUEHSG/AMEMBASSY SANTIAGO 5447
RUEHAC/AMEMBASSY ASUNCION 5369
RUEHMN/AMEMBASSY MONTEVIDEO 6189
RUEHPE/AMEMBASSY LIMA 2953
RUEHLP/AMEMBASSY LA PAZ 4520
RUEHCV/AMEMBASSY CARACAS 3209
RUEHBO/AMEMBASSY BOGOTA 3709
RUEHGE/AMEMBASSY GEORGETOWN 1043
RUEHQT/AMEMBASSY QUITO 1787
RUCPDO/USDOC WASHDC
RHEBAAA/USDOE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

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SIPDIS

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DEPT FOR EWHITE OES/EGC AND PKELLY OES/STC; OES/ETC GTHOMPSON
USDOE FOR SLADISLAW
DEPT PLEASE PASS TO USTR FOR MSULLIVAN
DEPT PLEASE PASS TO USAID FOR LAC/AA
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRSICOLL/MWAR D
USDOC FOR 3134/ITA/USFCS/OIO/WH/RD/DANDERSON/SHUPKA

E.O. 12958: N/A

TAGS: [TRGY](#) [SENV](#) [ENRG](#) [KSCA](#) [ETRD](#) [EAGR](#) [BR](#)

SUBJECT: THE ETHANOL DILEMMA - INADEQUATE SUPPLY VS GROWING DEMAND

11. Summary: As countries worldwide search for alternatives to increasingly expensive petroleum, not to mention green fuel alternatives that help meet Kyoto Protocol targets, Brazil finds itself in an enviable position. The world's largest producer of both ethanol and sugar is the purveyor of technology, infrastructure and processes that could help fuel a biofuel revolution. In fact, Brazil's ethanol program is so successful it has drawn the likes of Bill Gates and Google's founders, Sergey Brin and Larry Page, into the fray, promoting expanded ethanol production in the United States. Yet, despite the monumental success of ethanol in Brazil, it is not happening without some growing pains.

12. Brazil now finds itself in the unforeseen position of not having enough supply to satisfy demand. The unanticipated flex-fuel boom in Brazil coupled with increasing international demand for ethanol is exerting serious pressure on Brazil's domestic production apparatus.

Sales of flex-fuel cars reached approximately 80% of new vehicle sales in 2005. The resulting increase in demand for ethanol necessarily led to price increases. Moreover, ethanol exports increased by 1.8 billion liters in 2005 (a 269% jump over 2004). This facet of increased demand is compounded by the fact that foreign importers are offering a price 8-10% higher than Brazil's internal market. During the current interharvest period supplies are limited and prices have skyrocketed, leaving Brazilian consumers and officials with little hope for price reductions until production renews at the end of April. Taken as an omen, one of the most pressing questions facing Brazil is how to create an infrastructure which can deal with the escalated demand for ethanol.
End Summary

13. The question of how Brazil intends to address this supply and demand issue is still up for debate. In conversations with Scioff, Angelo Bressan, Director of the Ministry of Agriculture's sugar/alcohol division, noted that the GoB has only two ways to regulate ethanol. The first involves adjusting the requisite amount of ethanol to be mixed in gasoline. The GoB recently utilized this approach dropping the percentage from 25 to 20%. (reftel) Although

this measure increased supply, it had little to no effect on prices.

A second option would be to regulate ethanol exports by, for example, linking exports to domestic stocks via a system of quotas, but leaving prices free. This argument has been negatively received both by industry and free market advocates within the GoB. Unica (the Sao Paulo Sugarcane Industry Association) believes that this mechanism would not be able to function without government interference in pricing. Bressan noted that the GoB and industry have had an open dialogue focusing on how to address the problem of supply but without any decisive outcomes as of yet.

14. The sugar/alcohol industry, for its part, is looking to expand both the area of planted cane and the industry's capacity to refine it. Preliminary estimates are that US\$ 14 billion is going to be invested into refineries that can crush and produce sugar/alcohol by 2011. Meanwhile, another US\$ 7 billion is being invested into expanding cultivated land. Bressan added that 11 new refineries are already under construction with an additional 16 planned for 2007. That said, the analgesic effects of these investments are still some years away. Because it is not cost-effective to transport cane long distances, refineries and agricultural lands must remain in close proximity. Once a distillery is completed, there will still be a 12-15 month lag time (the crop cycle for cane) before production commences. Moreover, the upward swoop of land prices in cane producing regions (49% over the last year, compared to the national average of 2%), is certain to become an obstacle to the expanding industry.

15. This, of course, does not address the GoB's principal concern of how to maintain competitive prices for ethanol during the interharvest period. Bressan has stated that the GoB and industry are discussing palliative measures but failed to expand on what they

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were. They are simply "discussing the issue." The most prominent idea, reflected in numerous media accounts, is to create stockpiles of sufficient size to guarantee supply. While the industry and government agree to the idea in concept, both sides dispute who should be responsible for creating mechanisms and supplying the necessary funding for the stocks. While Roberto Rodrigues, Brazil's Minister of Agriculture, initially said that the government was studying inexpensive financing mechanisms for creating stocks, he later retracted those comments affirming that stocks are the responsibility of the productive chain.

16. In terms of Brazil and the United States, and the growing attention exhibited by parties like Gates, Brin and Page, and rising interest in California, Bressan noted that the Ministry would like to see U.S. tariff barriers dropped on combustible ethanol. But, he stated, it needed to be done in a systematic fashion. He fears that when the U.S. market opens, Brazilian consumers will be adversely affected by a dearth in supply resulting from profit hungry exporters. Bressan further maintained that the GoB has an interest in creating a world market and that the U.S. and Brazil should work together to achieve that goal. He added too, that countries, including the U.S., have a vested interest in working with Brazil because of the "know-how" they have regarding the production and processing of ethanol.

17. A crucial link in this process, from his perspective, will be spreading the supply chain throughout the developing world, especially in Africa and Asia. The U.S. and Brazil, he stated emphatically, are not capable of sustaining a world ethanol market on their own. That, of course, has not stopped the likes of Petrobras from signing a contract in February to build a pipeline from Goias (one of Brazil's principal cane producing regions) down to Brazil's largest port in Santos. A portent of how industry views the future role of ethanol.

18. Comment: In the short-term, it is clear that alcohol induced euphoria will continue the industry's ascension. As the world's largest producer of sugar and alcohol, Brazil is taking measures to increase production and at least discussing how to satisfy supply in the boom time. In response to the crisis over the last four months and the elevated prices, the GoB has recognized its impotence and is "throwing in the towel", waiting for the new harvest. This is

currently underway, and greater supplies of ethanol are expected in filling stations by early May. End Comment

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